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The End of the Merchant Model as We Know It

Over the next 5 years the merchant model as we know it will disappear. It will be transformed into a "Commission Override" convergence model | By Max Starkov and Jason Price

The explosion of the "merchant model" after 9/11 caught the hospitality industry by surprise. Over the last 4 years many hoteliers have been struggling to decrease their dependence on the online merchants and to develop direct online distribution strategies of their own. Hoteliers are also trying to find answers to several critical questions: does the cost of doing business with online merchants outweigh the cost of not doing business with them? What will be those crucial developments in the online hospitality marketplace over the next five years and what can hoteliers do to prepare for and take advantage of them now? This paper provokes thoughts that may help shape executive decisions under the current circumstances.

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Background:

The "merchant model" is a simple wholesale arrangement that involves net rates and room allotments with cut-off dates. The concept is nothing new and existed long before Hotels.com and Expedia, in the form of the FIT wholesale model fashioned with tour operators. Companies like Gulliver's have operated in this space for decades. The only difference is that in the past hoteliers did not allow wholesalers and tour operators to publish discounted/wholesale hotel rates (net + markup) if not bundled with other travel services.

Due to a lack of understanding of how online distribution worked, exacerbated by the industry- wide desperation after 9/11, hoteliers did not impose the same restriction on the online merchants. As a result hoteliers saw their discounted rates posted all over the Internet –on merchant sites and thousands of affiliates--and suffered severe consequence to rate and brand integrity.

While hoteliers gave up rooms at steep discount, online merchants became darlings on Wall Street. Hotels.com had a market capitalization of over $3 billion at one point. This unhealthy industry practice was best illustrated by one industry executive who described the state of confusion as "Selling Waldorf-Astoria on Hotels.com is like buying Armani in Wal-Mart." Since those days, hoteliers have sobered up, but the hangover still lingers and too many hoteliers are still having difficulty weaning themselves away and adopting better online distribution strategies.

The Internet is All About Efficiency

The Internet is all about transparency, efficient distribution of information, and inexpensive e-commerce transactions. It is the most efficient marketing and distribution medium ever invented. It is simply the best direct-to-consumer distribution channel ever created and it definitely favors supplier-buyer relationships. Nowhere is this better illustrated than between hotel and customer. Hoteliers that embraced their own direct online distribution efforts first and merchants second now enjoy as much as 40% to 60% of total revenues from their own websites.

In this sense the abnormally high margins of the merchant model (18%-30%) constitute a temporary anomaly, not the rule. That is because the merchant model contradicts the very nature of the Internet as an efficient and direct-to-consumer channel. The marketplace cannot tolerate deficiencies and abnormally high profit margins except on a temporary basis in periods of major industry transitions or during the emergence of entirely new distribution and marketing media (i.e. the Internet).

Travel is all about selling a dream, an anticipated experience. Selling a hotel stay over the Web does not require warehouses, complicated wholesale and retail arrangements, fulfillment centers, etc. Hoteliers know their product, destination, and customers better than anybody else. Just think about what a smart hotelier can do by employing rich media on the Web
(virtual tours, photo galleries, floor plans, interactive applications, etc).In this sense to market well online hoteliers do not need third party intermediaries, and can do the job themselves.

The proverbial "pendulum" has shifted back in favor of hoteliers. Major brands and savvy hoteliers are re-gaining control of the online distribution channel and have already proven that they can "dictate the terms of the online game" via tight control over properties, rate parity, best rate guarantees and successful loyalty programs (e.g. 75% of all Internet sales for Marriott come from the brand website)

The Merchant Model is already Evolving

The merchant model, used as the main business model by leading online intermediaries, is becoming more flexible due to the changing market conditions and increased pressure by travel suppliers: corporate contracts, lower mark-ups (e.g. 18%-22%), direct interfaces to the major brand CRSs, and last room availability on the hotel site. All of these concessions would have been unthinkable just two years ago.

This trend will inevitably accelerate over the next years as travel suppliers and major hotel brands continue to apply pressure on the online intermediaries in an environment of improved economic conditions and positive changes in consumer purchasing behavior.

The online merchants are embracing the dynamic packaging model as the next high profit margin generator. Dynamic packaging is a reincarnation, on a higher technology level, of the traditional FIT packaging that has existed since the advent of the GDS. This business model enjoys an increasing popularity among the online intermediaries. Why? It allows intermediaries to charge much higher mark-ups (e.g. 25%-35%) compared to the merchant model (e.g. 18%-25%). At the same time travel suppliers prefer dynamic packaging to the merchant model because it makes their distressed inventory and pricing opaque.

Forrester predicts that dynamic packaging sales will quadruple between 2004 and 2009. 68% of online travelers would consider purchasing a dynamic package (PhoCusWright Survey). All major online intermediaries have embraced the dynamic packaging model. Expedia, Travelocity and Orbitz report their dynamic packaging modules are the fastest growing segment of their overall bookings.

Comeback of the Agency Model?

The agency model (i.e. the old travel agency model that relies on supplier commissions, usually 10%) is beginning to regain at least some of its past luster as a result of the rate parity introduced by all major brands, and the lower merchant mark-ups negotiated by some of the major hotel brands (e.g. 18%). One of the typical merchants, Lodging.com, has negotiated straight commission override deals with some of the major brands.

Developments in Hospitality over the Next Five Years

Hospitality eBusiness Strategies firmly believes that the following crucial developments in the hospitality industry over the next five years will benefit hoteliers and other travel suppliers and help lessen their dependence on the online intermediaries and transform the merchant model as we know it:

Online distribution has become the #1 channel in hospitality:

- In 2005 over 25% of all hotel room revenue will be booked online. Another 25% of hotel bookings will be directly influenced by the Internet but done offline. In 2006 this percentage will exceed 27%-29%. Overall travel booked online will exceed 31%-35% of total bookings over the next 2 years. (PhoCusWright, HeBS). We expect that by 2009 over 50% of all hotel bookings will be performed online.

- The Direct vs. Indirect ratio in the online channel will follow closely with the offline channel (75:25) and will become as favorable as 80:20 in favor of the direct channel due to the diminishing role of call centers, travel agents, and traditional tour operators, rate parity and better channel control on behalf of the major brands).

Disappearance of the travel agency commission:

- In our view the standard travel agency commission, which is currently 10%, will disappear over the next 5 years in the same manner as it vanished in the airline and car rental sectors.

- The main reasons we believe standard agency commissions will disappear are: the diminishing importance of this channel and the GDS in general; the shift toward Internet distribution and rapidly changing consumer purchasing habits that favor suppliers; increased online expertise by the major brands, franchisees and independents alike; the improved economic situation. Once again: the Internet is all about efficiency and efficient distribution and provides a powerful alternative to the travel agency channel, which is a highly inefficient channel of distribution.

- Travel agency locations in the US have decreased by 10% every year over the past 5-6 years. From nearly 35,000 travel agencies in the US back in 1995, there were only 21,787 travel agencies in 2004, according to ARC, and as per current trends there will be less than 19,500 travel agencies by end of 2005. A growing number of travel agency bookings for hotels are already non-commissionable (preferred corporate rates, group rates, etc)

- For the first time in 2004 the Internet hotel bookings surpassed GDS hotel bookings and this trend will continue in the future. In 2006-2007 the Internet will generate twice as many hotel bookings as the GDS. Even now an increasing number of travel agency GDS bookings are non-commissionable transactions – as a rule preferred corporate rates are net, non-commissionable rates.

- In our view over the next several years the agency commission will shrink from the current 10% level to 8%, 5% and then will become a simple flat "Booking Reward" payment per reservation, most probably $5-$10 per booking by 2009. After that even this flat fee may disappear for good.

Direct Correlation between Agency Commission and Merchant Discount

The lower the standard travel agency commission becomes, the lower the merchant model discount granted by hoteliers will be. Volume producers will be rewarded with commission/flat booking reward payment overrides in the range of 50%-100% above the standard travel agency commission or flat booking rewards that exist at the time. If the standard agency commission is at the 5% level, wholesalers will get discounts at the 7%-10% level. No hotelier will be willing to grant a merchant discount to the tune of 25%-30%.

In this environment the marketplace will not tolerate the merchant model with its abnormally high margins and it will become a thing of the past.

The End of the Merchant Model

We believe that the merchant model as we know it will not exist five years from now in the U.S. 2005 will deepen and finalize the process of hoteliers getting the upper hand over online intermediaries.

From the major brands to savvy hotel management companies (HMC) to the individual hotel owner operator, each is firmly gaining control of their relationships with the third parties, and have instituted "preferred" or "approved" partner programs (similar to IHG). Franchisee direct contracts with the online intermediaries will disappear and will be folded into the corporate agreements with "preferred" or "approved" third parties. HMCs with multiple properties in the same destination can offer consumers a choice of hotels with their own destination sites, and independents are becoming increasingly choosy and very careful with their third-party relationships. The overall trend is to work with fewer "hotel friendlier" and carefully chosen online intermediaries.

Major hotel brands and many savvy hoteliers already operate in a rate parity and best rate guarantee environment and will continue to do so in the foreseeable future.

In the near future major brands and smart hoteliers will start introducing restrictions on how net wholesale rates can be marketed on the Internet by the third parties, which will gradually lead to a requirement that net rates should be bundled with other services and cannot be exposed "naked" on the Web (i.e. like it is today with the merchant model). As noted, such a requirement existed in the past.

HeBS firmly believes that the merchant model and the agency model will evolve over the next few years and converge into a "Commission Override" model where higher booking volume production will earn the intermediaries better commissions or overrides above existing travel agency commission levels, but at a fraction of today's abnormally high discounts of 18%-30%. As discussed above we expect the current 10% commission to shrink to 8% then 5%, in the end becoming a flat fee of $5-$10.

This convergence model will still require the online intermediaries to build direct interfaces to the major hotel brand CRSs to reduce distribution costs. Some of the savings realized by the hotel brands may be shared with the intermediaries.

Online intermediaries will further embrace and perfect the dynamic packaging model thus turning themselves into typical online wholesale packagers/tour operators. Dynamic packaging and addition of local sightseeing and entertainment will be the only chance of the online intermediaries to generate higher profit margins.

In addition to the dynamic packaging model which will become the norm, the online intermediaries will embrace the advertising model and start offering enhanced listings and positioning, pay-per-click (PPC) and display advertising programs, to supplement their decreased margins. A recent survey by Expedia actually probed hoteliers' attitude toward PPC and other advertising models.

Conclusions:

Over the next 5 years the merchant model as we know it will disappear. It will be transformed into a "Commission Override" convergence model. Travel agency commissions will shrink from the current 10% level to 8% then 5%, in the end becoming a flat fee of $5-$10. Online merchant operators will start earning volume discounts above current agency commission levels but at a fraction of today's levels.

Online intermediaries will further embrace the dynamic packaging model thus turning themselves into typical online wholesale packagers/tour operators, and start offering new advertising programs such as enhanced listings and positioning, PPC and display advertising.

What can hoteliers do?

Hoteliers should establish a "Preferred Partner" program and introduce stringent requirements the online intermediaries have to meet in order to qualify. Hoteliers have to create "Preferred Partner Guidelines" outlining these requirements. Hoteliers have to limit the number of third- party intermediaries they are doing business with and focus on their Direct Online Distribution and Marketing Strategies. Hoteliers have to start negotiating commission overrides to Preferred Partners as opposed to net rates.

Hoteliers should focus all of their efforts and resources on building and expanding their existing Direct Online Distribution and Marketing Strategies. Consider seeking advice from an experienced Internet distribution and marketing hospitality consultancy to help navigate the Internet and utilize the Direct Online Channel to its fullest potential. From experts who can teach hoteliers and their staffs best practices and provide crucial professional development, as well as guide hotel company's direct Internet distribution and marketing strategies, online brand building strategies, e-CRM, website optimization and search engine marketing strategies.